**Reference number: FS/2010/0038**

***Application for approval to perform Controlled Function CF30 – whether a fit and proper person – FSMA 2000, s 61 – integrity and reputation – competence and capability – financial soundness – conflict of interest – knowledge and understanding of investments recommended - proposal for remote supervision by applicant***

**UPPER TRIBUNAL**
**TAX AND CHANCERY CHAMBER**

**FIRST FINANCIAL ADVISERS LIMITED** **Applicant**

**- and -**

**THE FINANCIAL SERVICES AUTHORITY** **Respondents**

**TRIBUNAL: JUDGE ROGER BERNER**
**MRS JOANNE NEILL**
**ANDREW LUND**

**Sitting in public at 45 Bedford Square, London WC1 on 12 – 14 March 2012**

**Anthony Davies, Director, for the Applicant**

**Sarah Clarke for the Respondents**

DECISION

1. This is the reference of the Applicant, First Financial Advisers Limited, on the refusal by the Financial Services Authority ("FSA"), by decision notice dated 3 November 2010, of the Applicant's application for Mr Stephen Danner to be approved to perform Controlled Function CF30.

2. The basis for the refusal was that the FSA could not be satisfied that Mr Danner is a fit and proper person within the meaning of s 61 of the Financial Services and Markets Act 2000 ("FSMA") due to concerns about Mr Danner's:

(a) honesty, integrity and reputation;

(b) competence and capability; and

(c) financial soundness.

3. We should note at the outset that in the course of her closing submissions, Ms Clarke told us that she was not submitting that Mr Danner failed the test of honesty, but that the FSA maintained that the application should be refused on all the other grounds.

4. The issue for the Tribunal, accordingly, is whether Mr Danner has satisfied the Tribunal that he is a fit and proper person to perform the CF30 function.

**The law**

5. Applications for approval by the FSA of the performance by a person of a controlled function are made under s 60 FSMA. By s 61 of that Act:

> "(1) The Authority may grant an application made under section 60 only if it is satisfied that the person in respect of whom the application is made ('the candidate') is a fit and proper person to perform the function to which the application relates.
>
> (2) In deciding that question, the Authority may have regard (among other things) to whether the candidate, or any person who may perform a function on his behalf –
>
> (a) has obtained a qualification,
>
> (b) has undergone, or is undergoing training, or
>
> (c) possesses a level of competence
>
> required by general rules in relation to persons performing functions of the kind to which the application relates."

6. As Ms Clarke submitted, the burden of demonstrating that the candidate is a fit and proper person rests on the Applicant. This is material in this case, as Mr Davies submitted that the FSA had based its case effectively on consideration only of one case file directly handled by Mr Danner, and had asked only for examples of case files where clients of Mr Danner and investment advisers authorised through his firm,

SD Asset Management Limited ("SDAM"), had been recommended to invest in two FSA–authorised open ended investment companies: the CF Arch cru Investment Portfolio Fund and the CF Arch cru Specialist Portfolio Fund ("the CF Arch cru Funds"), and not other files where Mr Danner had advised on other investments.

7. We explain below why the focus of the FSA was on the CF Arch cru Funds, but we do not accept Mr Davies' submission that the FSA should have examined the files of Mr Danner more widely than they did in this case. The burden is on the Applicant; this is because it is the Applicant, either directly or through the candidate, who will have the relevant information that the Authority or the Tribunal should be invited to consider in support of the application.

8. This is not a case, such as was referred to in the recent Upper Tribunal decision in *Sime and another v The Financial Services Authority* (FS/2010/0040; 10 January 2012), where the FSA is seeking to rely upon unsubstantiated allegations which have not been investigated by the FSA. There is, as we shall describe, an ongoing investigation, and the FSA has considered case files, provided by Mr Danner, relevant to its concerns as to whether Mr Danner is a fit and proper person to perform the CF30 function. If there is other evidence material to the decision of the FSA and, on this reference, that of this Tribunal, it was for the Applicant to produce it. The Tribunal can determine the reference only on the basis of the evidence before it.

**Evidence**

9. We turn therefore to that evidence. For the Applicant we had witness statements and heard oral evidence from Mr Danner, from Mr Davies, in his capacity of Compliance Oversight officer of SDAM and from Paul Evans, part of whose professional activity has involved advising independent financial advisers ("IFAs") on the construction of investment portfolios, and who, from 2003, assisted SDAM in the re-development of its buy list and, from March 2006, assisted Cru Investment Management Limited with the design of a portfolio intended to be of low volatility.

10. The Applicant also filed and served a witness statement of Mark Rostron, a solicitor and partner of Hunt & Morgan Solicitors. The FSA gave notice that it wished to cross-examine Mr Rostron. As Mr Rostron did not in the event appear as a witness we have taken no account of his witness statement.

11. For the FSA we had witness statements and heard oral evidence from Natalia Stevenson, an associate in the Retail Asset Management team of the Investment Intermediaries Department at the FSA, part of the FSA's Supervision Division, and Rory Percival, of the FSA's Investment Intermediaries Department, who until recently was in the Retail Themes/Conduct Risk Department and who is that Department's leading expert on the suitability of investment advice. We also had a witness statement from Toyin Osaze-Omonuwa, an associate in the FSA's Approved Persons and Reporting Department, concerning her role as case officer for this application. Ms Osaze-Omonuwa's evidence was not challenged by the Applicant.

12. In addition to the witness evidence we had a number of bundles of documents, which we have considered.

**Background**

13. Mr Danner is an experienced IFA who for many years, up to its ceasing to carry on business, ran his own IFA business, SDAM. In that capacity he was the managing director (indeed, the sole director) of the company from its establishment in August 1999 to some time in 2007, when a Mr Stewart Wooles assumed the position of chief executive officer. At various times Mr Danner held a number of FSA authorisations. These were: CF1 (director), CF 10 (money-laundering reporting officer), CF11 (compliance oversight) and CF21 (investment adviser). For most of the company's existence Mr Danner was the sole director and effectively operating as a one-man band, with one part-time administrative assistant. However, during the latter period, with which we are concerned, a number of other independent advisers were authorised through SDAM. Those advisers were not employees of SDAM.

14. Mr Davies runs two businesses. One is the Applicant, First Financial Advisers Limited, an authorised independent financial advisory firm. The other is a management consultancy, The First Financial Consultancy, which specialises in providing advice on compliance with financial services legislation to IFAs. Since 1999 Mr Davies and his staff have provided various kinds of assistance at various times to SDAM. In January 2008, SDAM engaged Mr Davies to provide a comprehensive outsourced compliance service to SDAM. From that time Mr Danner and Mr Davies worked closely together as managing director and as compliance officer respectively, although Mr Davies' formal CF10 authorisation did not come through until June 2008.

15. From its inception, SDAM concentrated on generating revenue from client fees as opposed to transactional income from initial commission on product sales. SDAM's charges, which were agreed with clients in advance, were 1% of portfolio value per annum, payable monthly. Initial commission of up to 3% was taken on acceptance of new client funds. Mr Danner's evidence, which we accept in this regard, was that since this level of initial commission was the maximum available from the fund management industry, but less than half that available from certain insurance based investment products, limiting the initial commission to 3% was intended to give clients comfort that SDAM was acting in their best interests irrespective of product selection.

16. Furthermore, SDAM did not claim entitlement to additional commission, initial, trail or recurring commission on any switches made within the portfolio after the initial establishment charges. SDAM also altered the default position (on the trading platform, Transact) of a trading charge of 0.8% in order to establish a transparent transactional operating system where investors could be certain that recommendations to sell and re-invest were being made for investment reasons and not for increased commission for SDAM.

*The Cru Portfolio*

17. With a Mr Jon Maguire, Mr Danner established a new company, Cru Investment Management Limited ("CruIM"), in 2005. Mr Danner was, at the material times, both a director and shareholder of CruIM, which was a marketing company and an authorised representative of SDAM. The initial aim of Mr Danner was to design a portfolio that was less volatile than those typically held by SDAM's clients. Mr Maguire approached Mr Evans in March 2005 to assist with the portfolio design. Mr Evans had previously, from 2003, redeveloped SDAM's buy list with the aim of eliminating under-performing funds and concentrating on asset allocation taking into consideration client risk profiles.

18. The initial asset allocation of what became known as the Cru Portfolio was made up of UK Equity Income, various Global Bond funds and a 10% holding in specialist funds such as Eastern Europe, Asia, Technology and Smaller Companies. The aim was for the portfolio to be re-based monthly. The Cru Portfolio comprised publicly-traded funds, and did not have any element of private equity or private finance. It concentrated on reducing risk and attempted to control volatility through its asset allocation and fund selection. The portfolio was a moderate/low risk investment. But it was not itself an investment product, but merely a description applied to a strategy for a number of investments directly owned by the individual clients of SDAM. As such, those clients could see directly which unit trusts and OEICs they owned as a result of the Cru Portfolio.

19. Over a 17-month period the value of the Cru Portfolio increased by some 40%. However, it was perceived that problems were arising in relation to the rebasing of individual portfolios. Although Mr Evans did not elaborate on these problems we can infer from Mr Danner's evidence that one problem, at least, was the fact that portfolio changes would require the buying and selling of investments by clients directly, which would have tax implications for them. Mr Evans told us, and we accept, that Mr Maguire decided that it would be sensible to form an OEIC structure. This was done with Arch Financial Products LLP, whose managing director, Robin Farrell, was well-known to Mr Maguire, as investment manager.

*CF Arch cru Funds*

20. Two FSA-authorised open ended investment companies were established and launched in July 2006: the CF Arch cru Investment Portfolio Fund and the CF Arch cru Specialist Portfolio Fund ("the CF Arch cru Funds"). The Funds were administered by Capita Financial Managers Limited. The promotion of the Funds was carried out by CruIM, which received a marketing allowance from the CF Arch cru Funds of 1% of new money introduced into those Funds, whether through SDAM, one of its appointed representatives or elsewhere. The Investment Management Association ("IMA") placed the Funds in the Cautious Managed sector.

21. The structure of the CF Arch cru Funds was as overarching funds. These Funds themselves invested partly in established equity income funds (such as Invesco and Jupiter funds) and partly in a number of incorporated "cells" established as Guernsey funds and listed on the Channel Islands Stock Exchange. These single strategy funds

(Private Equity, Private and Structured Finance Funds and Sustainable Opportunities Funds) were themselves Arch cru Funds. The single strategy funds were cells of an umbrella Incorporated Cell company, Arch Guernsey ICC Limited. In the factsheets for the Funds for May 2007, for example, the CF Arch cru Portfolio Fund is shown as having 15% invested in Equity Income Funds, cash of 10%, 25% in Private Equity Funds, 30% in Private and Structured Finance Funds and 20% in Sustainable Opportunities Funds. By March 2008, according to a report by Richard Allen, the Fund had no exposure to UK equity income funds.

22. Although in his evidence Mr Danner described the change to the OEIC structure as the "incorporation" of the earlier Cru Portfolio, and it was referred to in the Funds' factsheets as a "conversion", it was not in any sense a mere change of structure or "wrapper". The underlying investments were very different. In September 2006 the CF Arch cru Investment Portfolio Fund was more than 40% invested in private equity and private finance. In August 2008, the total was over 60%. In July 2008, the Private Finance Fund, one of the cells into which the Investment Portfolio Fund and the Specialist Portfolio Fund invested, showed 92.9% invested in private finance (the balance of 7.1% being in cash).

23. Arch used a company called Parallel Private Equity LLP ("Parallel"), a substantial buyout house, to source the underlying private equity investments. Parallel operated in the mid-market (£10m to £250m) range in the UK and Europe. Parallel ran a co-investment model investing alongside other substantial private equity investors. The co-investment stakes were in the region of 5% to 20%. Parallel would not enter into a deal without undertaking their own due diligence, separately from the principal private equity house. According to Mr Evans' evidence, which in this respect was unchallenged, Parallel avoid highly leveraged deals and had a right of veto.

24. The September 2006 factsheet for the CF Arch cru Funds records that on launch in July 2006 those Funds had over £30 million of private client funds. In cross-examination Mr Danner accepted that about £25 million of SDAM clients' funds were invested in the CF Arch cru Funds, and that a little under 50% of SDAM's clients had been advised to invest in the Funds.

25. In the September 2007 factsheet the highlights are expressed as:

> +44.08% return since launch in May 2005
>
> 1st out of 73 Cautious Managed OEIC funds
>
> Outperforming all FTSE Private Banking Index series
>
> Over £130 million invested

The same factsheet shows the CF Arch cru Investment Portfolio Fund with an annualised return of 7.8% for the year to date up to August 2007, significantly higher than other cautious managed funds, and with an annualised volatility of under 1%; in this case significantly lower than the comparator cautious managed funds. A table also shows the CF Arch cru Investment Portfolio Fund as having a returns history of

44.08% since launch (30 April 2005), compared with bank base rate of 11.97% and an average for the cautious managed (OEIC) sector of 19.76%.

26. The factsheet describes the Arch cru Private Finance Fund as allowing the investor to participate in a highly diversified range of lending opportunities which offer the potential for double digit returns with low volatility and virtually no correlation to traditional investments such as listed equities or bonds. It claims that "the Fund gains exposure to a well diversified selection of private finance deals (typically over a thousand at any one time) with a view to achieving a target return of 11 – 15% per annum and minimum volatility."

27. We were taken to a matrix used by SDAM as a benchmark in September 2008. This set out portfolio recommendations for investors with varying appetite for risk. It was devised by Mr Danner in conjunction with a technical adviser commissioned by him, Richard Allen. The recommendation for a Low/Cautious Model Portfolio is 10% cash, 30% private finance in the form of the CF Arch cru Private Finance Fund and 60% absolute return in the form of the CF Arch cru Investment Portfolio Fund.

28. From the same document we find the SDAM Model Allocation & Risk Profiles. Key elements are:

(1) For a Very Low/Minimal risk profile, with an investment term of up to one year, the suggested recommendation is 100% cash. With a term of 3 – 5 years, the cash reduces to 40%, and the balance is recommended to be invested as to 40% in Private Finance and 20 % in Absolute Return.

(2) A Low/Cautious risk profile suggests in recommendations to invest in Private Finance as to 50% and Absolute Return of 40% over a 5-year term, with no investment in Property or UK or Global Equities. For a term of 5-7 years the Private Finance element reduces to 25%, Absolute Return is 50% and 10% is recommended into each of Property and UK Equities. A term of 8 – 10 years results in a recommendation of 15% in Private Finance, 40% in Absolute Return, 10% in Property, 20% in UK Equities and 10% in Global Equities.

(3) The volatility of Private Finance is shown as 1.26 and that of Absolute Return as 0.99 compared with Cash (0.09), Property (1.64), UK Equities (4.12) and Global Equities (4.31).

(4) The Asset Class Proxies used for these numbers are shown as:

Cash: IMA Money Market Sector

Private Finance: IMA UK Corporate Bond Sector

Absolute Return: IMA Absolute Return Sector

Property: Norwich Property Trust (as the only property unit trust/OEIC with a ten year track record)

UK Equities: IMA UK All Companies Sector

Global Equities: IMA Global Growth Sector

29. The SDAM Buy list for the fourth quarter of 2008 has two funds listed under Private Market, namely the CF Arch cru Investment Portfolio and the CF Arch cru Specialist Portfolio (the leveraged equivalent of the Investment Portfolio). It lists under Absolute Return the BlackRock UK Absolute Alpha and the Newton Absolute Intrepid, and under Private Finance the CF Arch cru Finance Fund (a reference to the CF Arch cru Private Finance Fund).

*The role of Mr Evans*

30. In his evidence, although it was acknowledged that he had not been involved in the production of the September 2008 matrix, Mr Evans was asked for his comments on it. His main concern was over the spreading of risk. In that context he expressed the view that he would not have recommended a Very Low/Minimal risk investor to invest as to 40% in Private Finance. He also agreed that 50% in Private Finance for a Low/Cautious investor would be unsuitable.

31. Mr Evans told us in evidence that he was not as familiar with the area of private finance as he was with private equity. He regarded private finance as a difficult area, one that was very different to private equity. He described private equity as a broad church, one in which it is difficult to assess what is high risk and what is low risk. His own view was that Parallel operated at very much the lower end of the risk spectrum within the private equity market, and that the private equity investments made by the CF Arch cru Funds were themselves not particularly high risk in comparison with what private equity could be, or in his words, "bottom end of the spectrum".

32. On the other hand Mr Evans emphasised the need to spread risk. As he colourfully put it: "… you have to spread risk. If you don't do that, you've had it." Mr Evans explained that the classification of risk in relation to any individual investment would be a crude measure unless the particular characteristics of the individual investment were properly understood. This includes information about underlying investments. Only with information of this nature could there be a proper approach to spreading.

33. At the inception of the CF Arch cru Funds Mr Evans became a non-executive director of CruIM, the marketing company. His main responsibility was to sit on the Arch cru investment committee with Jon Maguire and members of the Arch team. At around the end of 2007 clashes of personality had begun to arise between Jon Maguire and Robin Farrell. Mr Evans explained that this was due to Arch becoming increasingly reluctant, outside the private equity holding managed by Parallel, to clarify specific details of underlying investments to CruIM. Consequently the investment committee ceased to exist and all investment decisions were made without any input from CruIM.

34. Mr Evans formally left the organisation in February 2008, although his active involvement had effectively come to an end at the end of 2007. His departure was partly as a result of his own personality clash with Mr Maguire, but was significantly,

we find, due to his concerns as to the lack of transparency in relation to the underlying investments in the CF Arch cru Private Finance Fund.

35. Mr Evans shared these concerns with Mr Danner. Mr Evans maintained a dialogue with Mr Danner throughout 2007, after the initial funds in the CF Arch cru Funds had been invested. Mr Evans spent 3 days a week in Arch's offices in Albemarle Street in that period. Mr Danner recalled a meeting with Mr Evans in Brown's Hotel opposite Arch's offices, at which Mr Evans had expressed his concerns. Mr Danner said that Mr Evans was frustrated at not receiving details from Arch concerning some of the underlying investments. However, this conversation did not ring any alarm bells for Mr Danner; nothing Mr Evans said in this regard made him question the appropriateness or the soundness of the CF Arch cru Funds.

*Information relied on by Mr Danner*

36. In continuing to recommend the CF Arch cru Funds (and indeed invest his own pension fund in those funds) Mr Danner continued to rely on the information provided by Arch, in the form of factsheets and other performance data, on the pricing provided by Capita, on the classification of the Funds by the Investment Management Association as lower risk and as in the Cautious Managed Sector, and on independent research commissioned and paid for by SDAM.

37. The independent research was in particular that undertaken by Richard Allen of RichardAllenInvest. Mr Allen is a consultant who was engaged by SDAM and other independent financial advisers to research funds. He also assisted Mr Danner in the preparation of SDAM's investment matrix and buy list. His research activities for SDAM did not just comprise the CF Arch cru Funds, but covered other investments on the company's buy list.

38. Having been commissioned by SDAM to undertake research, and having interviewed the fund managers, Arch, Mr Allen produced a report in March 2008 on the CF Arch cru Funds. We were taken in particular to the report on the Investment Portfolio. The report describes the unique nature of the Portfolio, investing predominantly in unquoted private market assets including private equity and private finance (debt), as well as private market sustainable opportunities. The report acknowledges that those assets are not readily realisable and are therefore illiquid, without a publicly quoted market price, and that this inevitably gives rise to question marks over the liquidity and valuation of the underlying assets.

39. We consider this report in greater detail later, but its conclusions were as follows:

> (1) The CF Arch cru Investment Portfolio ("the fund") should be perceived as being an equity and bond fund with its asset allocation being compliant with the criteria required for inclusion in the IMA Cautious Managed sector.
>
> (2) Mr Allen "would contend" that the risk profile of the fund is no greater than that of a fund of investment trusts, and it could be argued that the fund is lower risk due to the absence of quoted equity market volatility.

(3) The inclusion of a non-equity component, via the private finance exposure, also reduces the fund's risk vis a vis a conventional fund of investment trusts.

(4) There is certainly a greater expectation that the cells will trade closer to net asset value than with most conventionally listed investment trusts and the master fund's returns be more stable as a result.

(5) Whilst there is some element of a 'trade-off' between volatility and liquidity inherent in the fund's structure, liquidity concerns are primarily, and to a large extent, negated by the 'ring-fenced' nature of the cells, the ability to dispose of shares in the cells in the secondary market, the discount management mechanism afforded by the cell directors' borrowing facility, the potential for the cells' participation in the underlying companies to be passed on to others of Parallel's partners and the high level of saleability of the majority of the underlying holdings within a relatively short period of time. That, though, is not to say that the value of the fund's assets cannot ever either fall or go to a discount to their net asset value.

(6) Valuations appear conservative in the context of the returns that (a) are expected from the private asset class, and (b) have been achieved, albeit historically, by Parallel.

(7) That the fund has made positive returns in months, including January 2008, in which equity markets have fallen very much highlights the fund's unique feature, that of its non-correlation and alleviation of the volatility associated with quoted equity markets.

*SDAM client files*

40. Of the 10 case files examined by the FSA, only one (relating to a client whom we shall call Mr A) was directly advised by Mr Danner. We were taken to that file, and Mr Danner was cross-examined on its contents.

41. Mr Danner reviewed Mr A's then current financial circumstances at a meeting on 12 November 2008. This was followed by a report in respect of which Mr A confirmed on 16 December 2008 that he had received, read and fully understood the recommendation. At that time Mr A was approaching the age of 65. On Mr A's instructions Mr Danner's advice was restricted to Mr A's retirement planning.

42. The report sets out that Mr A required a net yearly income of £12,000, which was substantially met from State pension and an entitlement under another scheme. At the time of the recommendation, therefore, an income of £2,000 was required from Mr A's personal pension plans.

43. The report also notes the Fact Find that formed the basis of Mr Danner's recommendations and advises Mr A to ensure that all particulars are correct and that SDAM's assessment of Mr A's attitude to risk is accurate. The Fact Find was scrutinised in cross-examination of Mr Danner. The client file contained a computer-generated page which recorded Mr A's attitude to risk as:

> Investments: Low/Cautious
>
> Pensions: Very Low/Minimal
>
> Savings: Low/Cautious

By contrast, the recommendation report states that, based on Mr A's responses to the questions posed during discussions, Mr A's risk rating had been categorised as that of a Low/Cautious to Medium/Balanced risk investor.

44. Challenged on this discrepancy, Mr Danner's evidence was that the Fact Find would be transcribed from written notes by an administrative assistant, some time after the fact find had taken place. Mr Danner's only explanation for the difference between what had been recorded on the computer and what was in the report was that an administrative transcription error had been made. He pointed to the fact that Mr A would have seen only the report and that Mr A had confirmed his understanding of the recommendations based on the risk profile set out in the report.

45. We accept Mr Danner's explanation, which seems to us to be the most likely reason for the discrepancy. We do not believe that Mr A would have failed to point out an error in the risk profile contained in the report. We therefore conclude that Mr A's attitude to risk in respect of pensions was not, as stated in the computer-generated document, Very Low/Minimal. We find that the risk profile for pension purposes was Low/Cautious. The recommendations were confined to Mr A's pension, and the recommendations were made under the heading "Recommended Low/Cautious Model Portfolio".

46. Of a total sum of £212,063, Mr Danner recommended that £3,015 be retained in a cash fund, £50,000 be invested in the CF Arch cru Investment Portfolio Fund, and £159,048 in the CF Arch cru Finance Fund, a reference to the CF Arch cru Private Finance Fund. Mr Danner states in the report that the CF Arch cru Finance Fund has been recommended because it seems better positioned to meet Mr A's requirement for a low risk investment, with less dependence on quoted holdings which, he says, were proving to be rather volatile in the then current very nervous environment. Mr Danner records the Fund as having produced a return of 26% since February 2007 in markets that had seen unprecedented volatility, banking failures and a global financial crisis. In relation to the CF Arch cru Investment Portfolio (Absolute Return), Mr Danner describes this as an innovative fund giving access to a number of asset classes, predominantly in the private, unquoted, arena, which are not usually available to retail investors in the UK. In terms of overall risk, the view is expressed that the Fund has an overall level of risk commensurate with that of the IMA Cautious Managed sector of which it is a constituent.

47. Under the heading Conflict of Interest is the following section:

> "The formation of cru stems from a decision in 2005 that the success of SDAM's portfolio management approach should be offered to other IFA firms, under a stand-alone brand name, cru Investment Management. That also enabled clients of SDAM to move from directly held fund investments to a single collective investment structure, the CF ARCH cru funds. This structure provides for greater

> tax efficiency, reduced dealing costs, far less paperwork and far more importantly, access to private market investments. The principal shareholders and directors of SDAM are also the founder shareholders of cru Investment Management plc. Directors and shareholders of SDAM will, therefore, benefit financially if clients of SDAM invest in any of the cru funds. However, this has not influenced any of the recommendations to you. We believe that the cru portfolio funds remain market leaders in delivering returns well above cash deposits with minimal volatility."

48. Mr Danner was cross-examined on a number of other client files. Although he had not personally advised on those files he accepted that he had overall responsibility due to his various FSA authorisations in relation to SDAM. Having reviewed the 10 files that were subject to Ms Stevenson's review, the only material fact we find from them is that in six out of those 10 files relevant conflicts of interest were not disclosed to clients before recommendations were made to invest in the CF Arch cru Funds.

*Suspension of CF Arch cru Funds*

49. Dealings in the shares of the CF Arch cru Funds was suspended on 13 March 2009. At the time of suspension investors had invested approximately £367 million in the Funds, including £83 million of retail clients' money. The Funds had invested predominantly in 23 listed Guernsey cells also managed by Arch. The cells had significant cross-holdings in each other.

50. The creditors' report dated 25 March 2010 on the liquidation of CruIM given by Mr John Cullen FCCA FABRP, as joint liquidator, from information provided by Mr Maguire contains the following statement:

> "Arch committed the CF Arch cru Funds to private markets and growing stress in global finances started to put the funds under valuation stress and liquidity issues also grew. In late 2008 the Investment Portfolio fund suffered some £30m of redemptions and there was concern that the fund should be suspended as it was finding it difficult to sell private market holdings to generate the cash to meet redemptions. The situation stabilised but it is believed that Capita and the FSA had concerns about the nature of the private market assets and their values and so suspended the entire fund range in March 2009."

51. Mr Danner resigned as a director of CruIM on 9 January 2009, but remained as a shareholder.

52. Between 20 May 2009 and September 2009, the FSA conducted a desk-based review of SDAM's procedures. A supervision visit was carried out by Natalia Stevenson on 7 October 2009. As appears from a subsequent letter dated 10 March 2010, the FSA considered that the findings from the supervision visit gave rise to serious cause for concern regarding SDAM and Mr Danner. As a result, on 28 June 2010, the FSA appointed investigators to conduct an investigation into Mr Danner's activities as an approved person at SDAM and into SDAM itself. At the time of the hearing this investigation was continuing.

**The FSA's case**

53. The FSA submits that the Tribunal should not be satisfied that Mr Danner is a fit and proper person to be approved as a CF30 on three grounds:

(1) Mr Danner failed to appreciate and/or manage conflicts of interest appropriately or at all.

(2) Mr Danner lacked sufficient knowledge and understanding of investments to assess the risk and suitability of the CF Arch cru Funds that SDAM was recommending to its clients.

(3) Financial soundness.

**Conflicts of interest**

54. Ms Clarke submitted, and we accept, that a failure to appreciate or manage conflicts of interest goes to the question of a person's integrity and reputation, and also competence and capability.

55. Ms Clarke submitted that the evidence demonstrated that Mr Danner did not, at the time he was recommending that clients of SDAM and its authorised representatives should invest in the CF Arch cru Funds, appreciate that any conflict of interest was present as regards his interest in CruIM, or that such a conflict of interest was significant. Furthermore, on the evidence given by Mr Danner and Mr Davies to this Tribunal, Ms Clarke submitted further that even now Mr Danner, and arguably Mr Davies, did not understand the significance of the conflict.

56. Ms Clarke pointed to the evidence that some £25 million of clients' money was invested by clients of SDAM into the CF Arch cru Funds. That represented something in the order of 7% to 8% of the total investment into those Funds. Mr Danner stood to benefit from these investments as a consequence of the marketing allowance paid by the CF Arch cru Funds to CruIM.

57. Mr Danner accepted that, until Mr Davies had come on board with SDAM in January 2008 to take over responsibility for compliance at SDAM, he had not considered the possibility of the interest he had in CruIM giving rise to a conflict of interest. No specific reference to such a conflict, or potential conflict, had been made in recommendations made to SDAM's clients up to that time. Nor had the issue of a potential conflict been picked up by a compliance audit carried out for SDAM by the independent compliancy firm, Simply Biz, in late 2006.

58. The matter of Mr Danner's common interests in SDAM and CruIM first came up on 27 February 2008 when, as part of the compliance function handover, one of Mr Davies' colleagues, Andrew Chatt, spent a day at SDAM carrying out file reviews. The feedback of Mr Chatt to Mr Davies indicated that there was a need formally to disclose the common interests that Mr Danner held in the two firms. Mr Davies then wrote to Mr Danner and Stewart Wooles (the then CEO of SDAM) as follows:

> "With Steve [Danner] we discussed what I perceive to be the need for more disclosure, when SDAM clients are recommended to invest in cru

> funds, of the connections between the firms; and the need for good justification of such recommendations."

59. Shortly afterwards Mr Davies prepared wording for a "Conflict of interests" paragraph to be included in the Terms of Business and suitability reports of SDAM, disclosing the connections with CruIM. This was circulated for comments to Mr Danner and Jon Maguire. Mr Maguire proposed alternative wording. Mr Davies then crafted wording which combined text from his own original draft and Mr Maguire's draft. Mr Davies' evidence was that the revised wording was incorporated into SDAM's Terms of Business letter on 9 May 2008 and in suitability reports from 28 May 2008.

60. Mr Davies' evidence was that Mr Danner responded promptly and positively when asked to disclose his connections to clients. Because Mr Danner had at that stage almost entirely detached himself from involvement in CruIM, and because his main business interest (SDAM) earned no extra income from recommending the CF Arch cru Funds, Mr Danner did not think that his various business connections created a significant conflict of interest. However, according to Mr Davies, Mr Danner was receptive to Mr Davies' argument that his various interests should be disclosed, and implemented the recommendations in a timely fashion.

61. We have described above the paragraph concerning conflicts of interest that was incorporated into the suitability report for Mr A. The evidence of the client files before us showed that in six out of the 10 cases conflicts had not been disclosed, but in each case the client file in question pre-dated the implementation, in May 2008, of Mr Davies' advice. We are therefore satisfied that the conflicts of interest language was included in the suitability reports for SDAM clients from 28 May 2008.

62. Before that date, as we have described, there was no formal disclosure of the conflict represented by the interests of Mr Danner in SDAM and CruIM respectively. Mr Danner's evidence was that, as the majority of the clients moving into the OEIC structure had also invested in the Cru Portfolio, those clients would in any event have been aware of the existence of CruIM and the Cru Portfolio. He said in evidence that on this basis he did not see where the conflict arose. Mr Danner also made the point that all SDAM's clients who were invested in the Cru Portfolio had been invited to attend a seminar on the launch of the CF Arch cru Funds and that there had been an explanation at the seminar, on the first slide of the presentation, of the respective positions of SDAM, the CF Arch cru Funds and CruIM.

63. We were provided with details of the income derived by Mr Danner from CruIM for the period 2005 to 2009. This information was shown in a document produced by Mr Danner in support of a statement of means filed with the FSA. For years 2005 and 2006, the document shows no salary, dividends or benefits in kind being enjoyed by Mr Danner. In 2007, he received salary of £36,405, net dividends of £90,000 and benefits in kind (for expenses) of £26,857. In 2008, the figures were: salary £6,205, dividends (net) £115,000, benefits in kind £36, along with a sale of shares recorded at £118,475. In 2009, Mr Danner received salary of £15,246, net dividends of £160,000 and £705 in benefits in kind.

64. We accept that the benefits that Mr Danner personally received from his interest in CruIM were not solely related to the introduction of funds into the CF Arch cru Funds from SDAM investors. The marketing allowance that CruIM received was a percentage based on the total of new investments received by the Funds, the vast majority of which was obtained from sources outside SDAM. Mr Danner, and on his behalf Mr Davies, sought to characterise the conflict of interest as a "potential" conflict, as the introductions of the funds of the SDAM clients had not themselves resulted in any financial benefit to Mr Danner. The argument was that, since the majority of SDAM clients would have transferred funds from the Cru Portfolio to the Funds in 2006 (a year in which no salary and dividends were paid to Mr Danner), any marketing commission derived from the introduction of those monies into the Funds would have been exhausted in the costs of setting up, and so would not have qualified for dividends.

65. We do not accept the argument of Mr Danner and Mr Davies in this respect. The mere fact that actual benefits received by Mr Danner cannot be traced to particular investments made by SDAM clients does not mean that there was no conflict of interest. Nor do we accept that for this purpose there can be any distinction between a conflict of interest and a potential conflict of interest. If the use of "potential" is intended to denote a circumstance where a person may become entitled to receive benefit from an interest that could be in conflict with a duty, but at the material time there has been no such receipt, then that in our judgment is a real and present conflict, notwithstanding that the benefit has not crystallised, or indeed may never do so.

66. Our conclusion in this regard is supported, to the extent that it needs to be, by the guidance on types of conflicts in that part of the FSA Handbook dealing with systems and controls, in particular SYSC 10.1.4. Point (2) of that section refers to whether the firm or a relevant person has an interest in the outcome of a service provided to the client, or of a transaction carried out on behalf of a client, which is distinct from the client's interest in that outcome. It is only necessary that there be an interest in the outcome, not that the interest has crystallised. Accordingly, once something can be described as a potential conflict, it is already an actual conflict of interest.

67. In any event, in the case of Mr Danner benefits were obtained that can be directly related to the investments by SDAM clients. Those benefits were the amounts of marketing allowance derived by CruIM as a percentage of the new funds introduced into the CF Arch cru Funds by SDAM. It is of no consequence how the income received by CruIM was applied once it had been received. If the income was expended in payment of costs, that is nevertheless a benefit; otherwise the costs would have to have been met out of other resources. Similarly, the fact that no dividends were paid in 2006 does not lead to the conclusion that the investments by SDAM clients did not benefit Mr Danner in his capacity as a shareholder in CruIM; on the contrary, the distributable reserves of the company, out of which Mr Danner subsequently received dividends were enhanced by the elimination of a loss that would otherwise have arisen if expenses had not been met through the payment of the marketing allowance in respect of the SDAM investments.

**Knowledge and understanding**

68. Mr Davies submitted that this case amounted to the FSA seeking to deprive Mr Danner of his livelihood as a financial adviser on the basis of an examination of only one client file where Mr Danner had himself given the investment advice. As we indicated earlier in this decision, we do not accept that as a valid criticism, having regard to the burden of proof. If, as Mr Davies suggested, this case ought more properly to have been determined on a more representative sample of Mr Danner's work, then it was for the Applicant to put that forward, both to the FSA and to this Tribunal. We can only make our decision on the evidence presented to us.

69. Mr Davies accepted that the question of the level of risk in the CF Arch cru Funds is significant because of its implications for Mr Danner's judgment, and consequently whether he is a fit and proper person. He submitted that there was no evidence that, at the relevant time, the Funds were considered to be anything other than Low Risk. Mr Davies further referred to the evidence of Mr Evans. However, although Mr Evans took the view that the private equity investments of the Funds were at the lower end of the spectrum of risk in the private equity sector, he was less sanguine over the Private Finance Fund. Mr Davies referred to literature issued by Capita and Arch, referring to the Funds as Low Risk, to the classification by the IMA as part of the Cautious Managed sector, and to the authorisation of the Funds by the FSA on the basis of information as to the objectives of the Funds and their description as Low Risk.

70. Ms Clarke submitted that Mr Danner's lack of knowledge and understanding went to issues of integrity and reputation as well as competence and capability, and thus to suitability. She referred us to the matrix and portfolio which, with the exception of a very cautious investor looking to invest for under one year, was the benchmark for recommendations for investment, to a greater or lesser extent, in private equity and private finance. Although other funds were listed under Absolute Return, the only private equity and private finance recommendations were the CF Arch cru Funds. Ms Clarke invited us to consider that the clients of SDAM were being channelled towards those Funds. She referred to the evidence of Mr Evans that he did not consider the matrix recommendation that significant investments be made into private finance was a suitable one for a low-risk investor.

*Evidence of Mr Percival*

71. At this point we turn to the evidence of Mr Percival. Mr Percival produced a witness statement in the form of an expert witness report. He was cross-examined by Mr Davies. We find the following to be the material conclusions to be drawn from Mr Percival's evidence.

72. The CF Arch cru Investment Portfolio Fund was not Low Risk. It should have been rated higher than Low Risk on the generally accepted industry categorisation of risk.

73. The risk rating of the CF Arch cru Investment Portfolio Fund was higher than Low Risk at the time Mr Danner was recommending it to SDAM's clients.

74. In this connection Mr Percival commented, in his evidence to us, on the broad spectrum of risk when considering different types of private equity investments, an analysis that, as we have described, was offered by Mr Evans in his evidence. Mr Percival made the point, which we accept, that private equity investments remain equities, with all the risk characteristics associated with that asset class. Listed equities are accepted (and in this respect we were referred to the course book of the Chartered Insurance Institute) as having a profile of above average risk. It follows therefore that the bottom end of the risk spectrum for private equity – however broad that spectrum might be – is still above a moderate/balanced level of risk for a client.

75. Contrary to the Applicant's assertion that "historically, risk was synonymous with volatility", volatility is not, nor ever has been, the sole measure of risk. Volatility is merely one of a number of measures of risk. Others include range, maximum drawdown, and value at risk. Volatility has two disadvantages as a measure of risk: first, the measure only considers daily pricing variation and hence suffers a significant flaw when used with assets that are not traded on a regular (typically daily) basis, and secondly it is backward looking. Volatility is thus a very poor measure of risk in relation to a fund of assets, such as private equity and private finance, that are not regularly traded on a market.

76. We noted above that the CF Arch cru Investment Portfolio Fund itself invested in a number of investment cells that were themselves listed on the Channel Islands Stock Exchange. However, we had no evidence that the interests in those cells were themselves regularly traded on that market. Volatility was worked out using the daily prices for the underlying assets, but the assets were not valued daily by the market. The real market value is unlikely to be reflected in an accountancy-based valuation.

77. Other key risks associated with investments such as private equity and private finance include the greater risk of default or firm failure, the risk of difficulty in finding buyers, liquidity risk and governance risk. Volatility reflects the extent and speed of daily price valuations only and hence these other risks are not reflected in the volatility rating at all.

78. Mr Percival stated that Mr Danner appeared to have been aware of some of the wider issues surrounding risk from what appears in the following extract of the recommendation for Mr A:

> "The classification of investment funds according to risk can be based on a number of factors. They may include, but are not necessarily limited to, the following:
>
> - Degree of fluctuation in value experienced by the fund in the past.
> - Risk assessment of underlying asset (e.g. Government Bonds compared with smaller company shares).
> - Political risk assessed on a geographical basis (e.g. UK compared with Emerging Markets).

- Currency Risks i.e. where values need to be converted back into Sterling.

The rating may reflect the degree to which a fund's unit price has fluctuated over a given period or may be based on the proportion of the fund held in each investment sector. Investors should understand that risk ratings assigned to funds only act as a guide, and that there is no universally accepted scale utilised by providers of financial advisers for measuring risk."

79. This indicates, as Mr Percival comments, that Mr Danner was aware that volatility was not the sole measure of risk. However, he comments further that Mr Danner appears to have overlooked or inadequately considered the risk assessment of the underlying assets in evaluating the risk attached to the CF Arch cru Investment Portfolio Fund.

80. In his report Mr Percival asserts that Mr Danner ought also to have been aware that the CF Arch cru Investment Portfolio Fund was not Low Risk for three further reasons:

(1) The Fund had similar holding to those of the CF Arch cru Specialist Portfolio Fund, which was described as "higher risk/reward investment approach" and "high growth". In making this comparison, however, Mr Percival does not allude to the element of gearing present in the Specialist Portfolio Fund, which leads to increased risk. Mr Percival also accepted in cross-examination that this description was comparative, and that it did not indicate that the Specialist Portfolio Fund was at the high-risk end of the spectrum. In fact, the January 2009 Arch monthly report described the Specialist Portfolio Fund as suiting investors with a medium level of risk appetite. We do not therefore accept this as a factor to be relied upon.

(2) Mr Percival made the uncontroversial statement that there is a link between risk and reward. He made the point, by reference to information published about the Funds, that the returns from the Funds were clearly substantially different from the sector average. This, he opined, should have alerted Mr Danner to the possibility that the risks were substantially different. To illustrate this he referred to the August 2008 factsheet for the Investment Portfolio Fund, which quoted the following performance figures:

| Period | Investment Portfolio Fund | Cautious Managed sector average |
|---|---|---|
| 1 year | +7.77% | - 6.48% |
| 2 years | +17.46% | - 1.29% |
| Since launch (April 2005) | +54.04% | +12.62% |

Over the two-year period it was accepted by Mr Percival that the annual return averaged at around 8% per annum. It is true, as Mr Percival pointed out, that the growth since launch (April 2005) was described in the August 2008

factsheet as equating to 13.8% per annum. However, those figures are distorted by including, from April 2005 to July 2006 pro-forma figures based on the performance of segregated investor portfolios allocated according to the Cru Portfolio. The CF Arch cru Funds were not launched until July 2006, and it was not until later in that year that the Funds were fully invested. The return of 13.8% did not therefore reflect the actual performance of those Funds; the better indicator is the performance in the two years up to August 2008.

Accordingly, whilst we accept the point that Mr Percival makes concerning the comparative performance of the Investment Portfolio Fund, we do not accept, as an indication of actual performance, the figures from April 2005.

In this context we note that in evidence Mr Percival accepted that a return of 4% per annum over the return on cash for an equivalent period would not be a particularly high level of return.

We note, on the other hand, that in the September 2007 factsheet, the Private Finance Fund is described as having a target return of 11 – 15% per annum, and for 2007 (the figures referring to the actual fund price from February 2007) the monthly performance data shows a year to date figure up to August 2007 of 13.18%. This can be compared with bank base rate in November 2008 (at the time the recommendations were being made to Mr A) of 2 per cent.

(3) Mr Percival points also to the link between the size of the underlying assets and risk. He contrasts the position of large public companies with medium-sized companies and expresses the view that the former will typically be more financially secure. Likewise he contrasts medium-sized companies with smaller firms. He makes the point that private equity funds invest in unlisted companies which are generally smaller firms, and hence those underlying firms are much higher risk than large listed firms. He points to a number of indicators, including variable income and lower cash reserves that lead smaller firms to be more prone to cash flow problems.

This is clearly a statement made at a level of generality. We do not have information as to the precise nature of the holdings in the Private Equity Fund; the factsheet for September 2007 states no more than that the Fund invested in 'mid-sized pan-European' companies. However, we accept that the nature of the underlying investments should have given rise to enquiry as to risk.

81. We consider that what Mr Percival termed "Concentration risk" is an important factor. As Mr Percival described the position, diversification has always been a standard element in financial services. The concept of concentration risk was widely understood. We do not accept the Applicant's assertion that this nature of risk became a more important consideration in the years since 2008. There is clear evidence, some of which was referred to in Mr Percival's report, including academic research, that supports an earlier adherence to importance of the concept.

82. Indeed, Mr Danner's suitability report for Mr A makes specific reference to diversification. On the other hand, Mr Danner also sought to justify a departure from this approach when he said, in the suitability report for Mr A:

> "…during exceptional market conditions, as is currently the case, the use of a single asset class and/or fund, may reasonably be justifiable."

Mr Percival comments, rightly in our view, that the suitability report contains no adequate explanation of the reasons Mr Danner considered the circumstances merited a different approach to concentration. We agree with Mr Percival that exceptional circumstances merit a more cautious approach, and that would suggest not concentrating investments, or investing in lower risk funds. We also agree that, whereas some of the CF Arch cru Funds (for example, the Investment Portfolio Fund) involve some diversification across asset classes, it is the case that, even when diversified, a fund that holds a significant proportion of higher risk assets will be higher risk overall.

83. We referred earlier to the report made by Richard Allen for SDAM into the CF Arch cru Investment Portfolio Fund. Part of Mr Percival's evidence included comments on that report. It is most convenient, we think, for us to set out in tabular form the relevant extracts of Mr Allen's report, and Mr Percival's comments, which we have extracted, to some extent as edited by us, from the transcript of the hearing.

| **Mr Allen's report** | **Mr Percival's comments** |
|---|---|
| Uniquely in the UK retail market, this fund [that is, the CF Arch cru Investment Portfolio Fund] invests predominantly in unquoted private market assets … | In 2007 and 2008 retail funds generally did not invest in unquoted market assets … the mechanism of putting money in over a period of time and getting money out over a period of time fundamentally doesn't fit with private investors … |
| The aim of the fund is to deliver absolute returns i.e. positive returns irrespective of whether public equity and debt markets are either rising or falling. Thus the fund should, in theory, be relatively immune to volatility in such markets. | It aims to deliver absolute returns but it doesn't explain how it does that … volatility [is not] a sensible measure for unlisted securities. |
| Any liquidity issue that would arise should the master fund itself and, thus the underlying cells, experience redemptions is alleviated in two ways. Firstly, the private market assets themselves are effectively 'ring-fenced' by the closed-ended nature of the cells. If redemptions are necessary from the master fund, then the shares of the cells can be sold by the master fund on the secondary market. In this way, the underlying assets do not need to be liquidated.<br><br>Secondly, the cell's directors have the | If this is a report on the potential risks associated with the fund, or if this is a report to enable an adviser to advise on the fund where he would need to know the risks, I would expect it to cover the nature of what liquidity risks might pan out to be in adverse market conditions.<br><br>[The report does not explain] the risks associated with gearing.<br><br>[It does not deal with the downside of gearing] … That gearing accelerates and |

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| facility to borrow up to 30% of the cells' [sic] assets to fund the purchase of shares. Whilst there is certainly the potential for the cell funds' shares to go to a discount and, thus, the shares of the master fund to fall in value, this borrowing facility should allow any discount to be minimised and the cells' prices to be maintained as close to the net asset value as possible. | increases risk. |
| … the private finance component invests in short-term, typically one to three month, fixed rate loans – not bonds. | This is an entirely different type of investment to the corporate bonds that are being used as the proxy class in SDAM's matrix. |
| … the underlying capital value is insensitive to interest rate movements, unlike publicly traded bonds, as the interest rate is set at the outset of the loan. That said, the interest rate earned will change with interest rates as the loans are generally structured to be rolled over at the end of their term and renegotiated subject to the prevailing interest rates at that time. | (Question: what would a competent and capable IFA do on reading that?) … what level of interest rates were involved, how are they generated, what type of companies were involved and how is it that 11 to 15% can be achieved, and what's the potential downside to that. … It doesn't talk about the risk of default and capital loss. |
| In essence, the loans are not 'marked to market' and, therefore, their base capital value is not affected by external market factors. They can, however, be sold if necessary in the secondary market, though the value attained would not necessarily be that of the full value of the loan. | [A competent and capable IFA] would need to ask about that. It says you might not get the full value of the loans, but what does that mean? Is it that you would get 90%, 50%, 10%? |
| It should also be borne in mind that the loans are highly collateralised and that, there is, thus, a level of security and recoverability of the sum loaned in the instance of a borrower defaulting. Arch pays very close attention to the default and recovery experience of the underlying funds that are invested in, to which end the Arch managers speak to each fund manager at least once a week. | The question mark for me – and again if I put myself in the shoes of a competent adviser on this – would be monitoring the risk doesn't give me any information about what the level of that risk is. |
| There is a considerable degree of | (Question: In terms of retail investors |

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| diversification apparent within the private finance component. This comes not only through the diversification within the underlying funds themselves but, secondly, through the various funds held being invested in a range of different sectors and asset classes and, thirdly, through the policy of holding between twelve and sixteen individual funds. It can be anticipated that the fund will have exposure to more than 1,000 different loans at any one time. | with low or very low attitudes to risk, what would diversification normally mean for them?) It would be unusual for – I'm just trying to think through this. There is a question mark about whether a single asset class is going to be suitable for low risk investors. [Diversification] provides a better risk and reward balance, i.e. it reduces risk for the level of return you will get.<br><br>90 per cent in one asset class is not diverse. [40% to 60%] … you have a degree of diversification there. What you would then have to look at is what are the nature of the investments. You can diversify and reduce risk but you can't diversify high risk investments all the way down to low-risk investments. |
| In the absence of a market price, as with publicly quoted assets, there is a natural concern over how the underlying assets in the cells are valued. The guidelines are laid down by the British Equity and Venture Capital Association (BVCA), the industry body for the UK private equity and venture capital industry, are used to value the private equity holdings … valuations are undertaken by each underlying company's appointed auditors on a quarterly basis … | (Question: is there anything in here [the Valuation section of the report] that warns a reader of the risks inherent in the valuation of private investments?) I don't recall reading that, no.<br><br>(Question: Which is … that it is only when you come to sell it that you know what it is really worth?) Correct. |
| The CF ARCH Cru Investment Portfolio fund should be perceived as being an equity and bond fund … | (Question: Would you have described this fund as a bond fund?) No |
| I would contend that the risk profile of the fund is no greater than that of a fund of investment trusts. | [The value of this comparator is] almost nil, because you are comparing it with a fund of investment trusts, but funds of investment trusts have all sorts of different levels of risk. Some are fairly low risk and some are extraordinarily high risk. |
| Indeed, it can be argued that the fund is lower risk due to the absence of quoted equity market volatility, which, in the | I think there are two points here. One is, if you like, the sort of technical point about discounts widening and narrowing. |

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| case of most conventional investment trusts and without the ability to manage any discount through the borrowing facility, is compounded by discounts either widening or narrowing. | I don't put forward that the Arch cru Funds would have any particular issues around discounts widening or narrowing, but in the first part of it, saying that it is lower risk due to absence of quoted market volatility, if Mr Allen is an expert in investments and risk, he should be aware that volatility is not a good measure of risk in this scenario as I have outlined. |
| The inclusion of a non-equity component, via the private finance exposure, also reduces the fund's risk vis a vis a conventional fund of investment trusts. | [The value of that statement to a reader is that] it is saying there is diversification, as I read it. It is not giving you any more help than that, because it is not giving you any quantification of the risk level. |
| There is certainly a greater expectation that the cells will trade closer to net asset value than with most conventionally listed investment trusts and the master fund's returns will be more stable as a result. | That is talking about a very narrow scenario … around the difference between the net asset value, which is the underlying assets, and the share prices. So that is quite a narrow point.<br><br>Question: What does it tell you about the valuation risks, the risks of value of these sorts of funds?) It doesn't. |
| Whilst there is some element of a 'trade-off' between volatility and liquidity inherent in the fund's structure, liquidity concerns are primarily, and to a large extent, negated by the 'ring-fenced' nature of the cells, the ability to dispose of shares in the cells in the secondary market, the discount management mechanism afforded by the cell directors' borrowing facility, the potential for the cells' participation in the underlying companies to be passed onto other of Parallel's partners and the high level of saleability of the majority of the underlying holdings within a relatively short period of time. That, though, is not to say that the value of the fund's assets cannot ever either fall or go to a discount to their net asset value. | … it is recapping some of the earlier points. It is giving some generic points. It's not giving the full story, and it is not giving the magnitude of the potential losses. It's not giving a balanced representation of the risks. |

84. We should add that the report contained certain elements on which Mr Percival did not make specific comments. In relation to liquidity, the report makes the point that the master fund (that is to say the CF Arch cru Investment Portfolio Fund) contained a minimum amount of its assets in cash at all times. It notes that the model of co-investment alongside Parallel and the fact that this means that the relevant cell has only a minority holding and does not have "total control" over the disposal of investments. This therefore highlights one aspect of liquidity risk. However, the report goes on to say that participation in individual companies could be sold onto other of Parallel's institutional partners if necessary. But the report does not examine whether there was any set process for such a sale, or whether it would simply be an ad hoc negotiation at the relevant time; this would in our view have a material effect on risk. The report finally suggests that in the case of private equity Arch had estimated that, under normal market conditions, 60% to 70% of those assets of the CF Arch cru Funds could be liquidated within one month; however, the report contains no information to back up such a claim.

85. We noted above the comment of Mr Percival regarding the use in SDAM's matrix of the IMA UK Corporate Bond Sector as a proxy for the calculation of loss and volatility in Private Finance element of asset allocation. Mr Percival said, and we agree, that the matrix did not show, as asserted on behalf of the Applicant, that private finance had, over the previous 10-year period, a lower volatility than other asset classes, such as property, UK equities, global equities and "Specialist" (the proxy for the latter being the IMA Technology and Telecoms Sector). We agree with Mr Percival's observation that the UK Corporate Bond Sector is very different from that of private finance, with very different risks and very different returns. Mr Percival expressed the view, with which we concur, that this was a wholly inappropriate proxy. Accordingly the volatility comparison set out in the matrix could not (and should not) have been relied upon.

86. Mr Percival made a similar observation concerning the proxy for the Absolute Return element of the matrix. He said, and again we accept his observations and reasoning, that the use of the IMA Absolute Return Sector was inappropriate because the proxy relied, essentially, on derivatives to avoid excessive falls in value, whereas the Investment Portfolio Fund made it clear that it did not. Nonetheless, Mr Percival accepted that the Investment Portfolio itself had low volatility.

87. We have dealt at some length with Mr Allen's report, and Mr Percival's observations on it. We considered it right to do so, as Mr Danner and the Applicant placed considerable reliance upon Mr Allen's report as a source of independent comfort for Mr Danner as regards the CF Arch cru Funds. We are conscious that we did not receive evidence from Mr Allen in person, and so he did not have an opportunity to comment on Mr Percival's observations. However, in our judgment the observations of Mr Percival are apt, and we accept his comments on Mr Allen's report.

88. In his evidence Mr Percival also commented on the fact that the Investment Portfolio Fund was listed in the IMA Cautious Managed Sector. This was said by the Applicant to be regarded as generally suitable for low risk investors. He referred us to

the applicable definition from 2006 for a fund to be included in the Cautious Managed sector:

> "Funds would offer investments in a range of assets, with the maximum equity exposure restricted to 60% of the fund. There would be no specific requirement to hold a minimum % non-UK equity. Assets must be at least 50% in sterling/euro and equities are deemed to include convertibles."

89. In this respect we accept the view expressed by Mr Percival that the qualifying criteria relate to the broad nature of the assets in a fund and not directly to the risk rating. The sector could include, and in this case did include, funds with a distinctly different risk profile from other funds given the same classification. Inclusion of a unique fund in the Cautious Managed classification could not begin to give any comfort as to the proper risk rating to be attached to the fund.

90. It follows from our description of Mr Percival's evidence that, with the exception of those elements which we have described above, we accept his observations on the question of the risk rating that should have been attached to the CF Arch cru Funds. In our judgment, those funds were not properly described as Low Risk. This applies to all the Funds, although we would note in particular the Private Finance Fund which, on examination, appears to us to have characteristics that would merit a much higher risk rating than was attached to it, and was relied upon by Mr Danner in participating in the design of SDAM's matrix and portfolio and in making his own investment recommendations to a Low/Cautious investor such as Mr A.

**Financial soundness**

91. We heard evidence about Mr Danner's financial position. It was accepted that at the time of the Applicant's application to the FSA, and when the FSA made its decision, Mr Danner's financial circumstances were uncertain. Since that time there had been certain clarification, so that the only issue concerned a possible guarantee given (on a joint and several basis) by Mr Danner in relation to CruIM (in liquidation), the potential liability on which could amount to £997,000. Mr Danner told us, and we accept, that this debt is disputed. Mr Danner also accepted that if the debt of £997,000 or any substantial part of it were in fact due and payable, he would be in no position to pay it.

**Conclusions**

92. In assessing whether we consider Mr Danner is a fit and proper person to perform the CF30 function for which application has been made, it is necessary for us to take into account the context in which it is intended that that function be carried out. In correspondence by email from Mr Davies to Ms Osaze-Omonuwa dated 17 May 2010, Mr Davies described Mr Danner's proposed role as follows:

> "[It] will be to act as an investment adviser to his [Mr Danner's] former clients at SDAM and to any new clients he may obtain, mainly by referral from his established introducers. His customers will be

> retail clients, generally fairly high net worth individuals, living in South Wales wishing to make lump sum investments. He will be required to act in accordance with [the Applicant's] written Compliance procedures manual. Initially at least, he will be required to work under a 'trainee' regime: every proposed recommendation/transaction will be referred to Head Office for pre-approval. He will be required to follow our written T&C scheme, which includes a Training Needs analysis and Training Plan, periodic observed client meetings and meetings with his supervisor (myself), Key Performance Indicators etc."

93. In his evidence Mr Davies described the level of supervision that the Applicant intended be exercised over Mr Danner. Colloquially this was referred to as "24/7" supervision. The intention is that the Applicant's staff sit in Newbury, Berkshire with their computer switched on, and Mr Danner sits in Cardiff with his computer switched on, and the Applicant sets the computer to allow it to pre-approve anything that it requires to be pre-approved. The Applicant would want to see fact-finds, suitability reports and illustrations and "all the rest of it". Mr Davies said that in this way there was no problem bridging the gap between Newbury and Cardiff.

94. It is in that context that we have to consider the submission of Ms Clarke for the FSA that there has not only been a demonstrable lack of competence across all the areas considered in this case, but a lack of integrity and reputation. Looked at in the round, submitted Ms Clarke, the failings of Mr Danner were so fundamental as to go to the heart of everything the FSA is entitled to expect from an independent financial adviser, and that this therefore must go further than simply lack of competence and capability.

*Conflicts of interest*

95. We turn first to our findings in relation to conflicts of interest. In that regard, we have two concerns. The first is the failure by Mr Danner to appreciate at all what we consider to be an obvious conflict of interest arising out of his interests in SDAM on the one hand and CruIM on the other. We have rejected the argument that this was not an actual, but potential, conflict. We have likewise rejected the submission that Mr Danner did not benefit from the investments made at the outset by SDAM clients into the Funds, because the marketing allowance was used to meet set-up costs. In our judgment, in his position, Mr Danner should have been aware of the conflict of interest and sought to give proper disclosure of it to SDAM clients. The mere reference to CruIM at the roadshows, and general knowledge on the part of clients already invested in the Cru Portfolio was plainly insufficient.

96. The second concern is that, even at this stage, Mr Danner, and indeed Mr Davies on behalf of the Applicant, was not prepared to acknowledge the real conflict of interest that arose. It was not just a question of disclosure. The financial benefits accruing to Mr Danner through CruIM were not known to the SDAM clients at the time Mr Danner was recommending the CF Arch cru Funds, until, following Mr Davies' intervention, May 2008 Until Mr Davies' firm had pointed out the issue there was no recognition of the conflict, and certainly no effective management of it.

97. Mr Danner accepted that his approach to certain compliance matters, and to the conflict of interest issue, had been less than satisfactory. We accept that he took steps, following the intervention of Mr Davies, to rectify the lack of proper disclosure to clients. But the continuing failure to recognise the circumstances as giving rise to what appears to us to be a clear and present conflict of interest does cast doubt on whether Mr Danner is now a fit and proper person to perform the CF30 function.

98. FIT 2.1.3 in the FSA Handbook at para (13) requires regard to be had to the readiness and willingness of the relevant person to comply with the requirements and standards of the regulatory system and with other legal, regulatory and professional requirements and standards. We agree with Ms Clarke that it is appropriate for us to ask ourselves the question whether Mr Danner has demonstrated sufficient insight into the problem to recognise, firstly, that there was a problem, and, secondly, to acknowledge it so as to give the Tribunal confidence that should a similar situation arise again it would be dealt with in a different way. Mr Danner, and the Applicant in its application, has failed to give us that confidence.

99. Does the fact of the intended supervision of Mr Danner alter the position in this respect? In our view it does not. Although such supervision can, on the evidence before us, be expected to pick up conflicts that might become apparent through remote monitoring, that is not in our view sufficient. The doubts about the integrity of Mr Danner that arise as a consequence of his continuing failure to acknowledge the real significance of the conflict of interest that arose between SDAM and CruIM cannot be dispelled by reliance on systems to spot a problem if Mr Danner himself cannot.

*Knowledge and understanding*

100. Although the question of the proper risk classification of the CF Arch cru Funds is not determinative of this application, it is, as Mr Davies acknowledged, a significant factor in our consideration of Mr Danner's judgment, and of his knowledge and understanding of particular investments that were being recommended to SDAM's clients. As we recorded earlier, in our judgment none of the Funds ought properly to have been regarded at the relevant time as Low Risk. It follows, in our view, that those Funds ought not to have been marketed or recommended as Low Risk.

101. The question for us, therefore, is whether the circumstances of Mr Danner's failure to reach a similar conclusion, and the manner in which he employed the Funds in constructing SDAM's matrix and portfolio, and in recommending the Funds, leads us to conclude, in the context of the proposed supervision by the Applicant, that Mr Danner is, or is not, now a fit and proper person to be approved to perform the CF30 function. This is a question with a number of elements, which we consider in turn.

102. We consider first whether a competent and capable IFA, in the position of Mr Danner, would have appreciated that the Funds were not properly described or categorised as Low Risk, or at the least would have been sufficiently aware to have made more rigorous enquiry as to the nature of the risks attaching to the Funds. We

do not consider that this is a question that can be answered from a purely objective perspective. One has to have regard to Mr Danner's own knowledge and understanding at the relevant time, and also his position as one of the prime movers in the establishment of the Funds. That latter fact, in our view, places him in a special position, both as regards his own access to the Funds and those managing or administering them, and in his responsibility when recommending those Funds to his and SDAM's clients.

103. Mr Danner was candid in saying that he had no expertise in or experience of private equity and private finance. The idea for the OEICs had grown out of a desire to manage down investment risk, and out of the success of the Cru Portfolio. In part the motivation for a move to a different structure was the desire to create a "wrapper" that would provide tax and administrative benefits. But the new structure went much further than that. It is clear that Mr Danner understood well that the structural change was not merely to create a new structure for the Cru Portfolio, but that the nature of the underlying investments had undergone a material change; Mr Danner refers to this in his suitability report for Mr A. Mr Danner's evident appreciation of this change, coupled with his own lack of understanding, in our judgment made it especially important for him to take steps to acquire information on which he could confidently recommend the Funds to SDAM's clients.

104. Mr Danner relied on a number of sources of information. He relied on information from Arch, both directly and through factsheets and other published material, on Capita's pricing, and on independent research. We accept that Mr Danner's engagement of two independent experts, Mr Evans and Mr Allen, went beyond what a typical IFA might do in a normal case; but we do not consider that this was a normal case having regard to the uniqueness of the Funds and Mr Danner's close association with them. As regards the research carried out by Mr Allen, we have considered this in some detail, and have accepted Mr Percival's comments on, and criticisms of, that report. Mr Percival is, of course, an expert: we need therefore to consider what conclusions would have been drawn, or doubts and questions raised, by a competent and capable IFA in Mr Danner's position.

105. So far as the CF Arch cru Funds are concerned, we consider that Mr Danner's own assessment of risk was flawed. His approach relied too heavily on the comparative volatility of the Funds. In answer to a question from the Tribunal, Mr Danner confirmed that in his view volatility was the most significant measure of risk. This flawed approach was especially evident in the design of the matrix and portfolio, where it should have been readily apparent that the proxies for the Absolute Return and, in particular, the Private Finance elements were inappropriate. Volatility is one measure of risk, but it is only one, and in our view, in considering risk in the private equity and private finance sectors, it is not the most important of indicators.

106. We consider that a competent and capable IFA, including one with little or no experience of private equity or private finance, would have understood that volatility was not the most indicative measure of risk, and would have considered other measures or indicators of risk as described in Mr Percival's evidence. In the case of Mr Danner, this should particularly have included the need to understand the

underlying investments, having been put on notice by Mr Evans of a possible issue in that regard. Indeed, as the evidence of the suitability report for Mr A demonstrates, Mr Danner was aware that volatility was only one measure of risk. Nevertheless, we agree with Mr Percival that Mr Danner appears to have overlooked or inadequately considered the risk assessments of the underlying investments.

107. It is particularly noteworthy, in our view, that Mr Danner accepted Mr Allen's report on the Investment Portfolio Fund (and other Funds) without raising questions on its reasoning and conclusions, particularly as regards the risks attaching to the underlying investments, which should have been firmly in Mr Danner's mind as a consequence of Mr Evans' resignation. A detailed review of Mr Allen's report reveals a number of areas demanding further enquiry, and we are satisfied that these are areas that would have led a competent and capable IFA in Mr Danner's position to have raised further questions.

108. Mr Danner accepted that there was a link between risk and reward. We have analysed earlier Mr Percival's comments on this aspect, and have concluded that a return in the Investment Portfolio Fund of 4% per annum over the return on cash would not have given rise to a concern on this account alone. However, the position is different for the Private Finance Fund, for which returns of 11% to 15% were expressly targeted, and which achieved 13.18% on a year to date basis up to August 2007. Furthermore, in his suitability report to Mr A, Mr Danner recorded the Private Finance Fund as having achieved a 26% return in the period from February 2007 to November/December 2008. In our view, that level of return would, in the case of a competent and capable IFA, have given rise to enquiry as to the classification of that Fund as Low Risk.

109. Mr Danner placed reliance on the placing of the Funds in the IMA Cautious Managed Sector as providing reassurance as to the appropriate level of risk. However, the very nature of the Funds (which were unique), and their performance relative to the other funds in that sector should not, and here we concur with Ms Clarke, have provided Mr Danner with reassurance as to the risks attached to the Funds, but should have done quite the reverse. Furthermore, despite being relied upon by Mr Danner, we do not consider that the obtaining of FSA approval for the Funds can be in anyway indicative of the risk classification of the Funds; it can be no substitute for a proper analysis by individual IFAs of the risks attaching to such investments.

110. We also consider that a competent and capable IFA would have been more concerned as to the liquidity of a fund of unquoted private equity investments and private loans (not bonds). Mr Allen's report described methods by which the obvious liquidity risk would be alleviated, but the report failed to address what we consider to be a clear question mark, namely the effect on risk of gearing up in order to finance fund redemptions. Mr Allen's report in this respect appears to us, and would in our view have appeared to a competent and capable IFA in Mr Danner's position, as concentrated on pricing, and not on the effect on risk. We also consider that further enquiry should have been made by Mr Danner, and would have been made by a

competent and capable IFA, as to the ability of the Funds to procure a quick sale of their private equity holdings.

111. We referred above to concentration risk as an important factor. We do not consider, and in our view Mr Danner should not have accepted, that diversification within the Funds, in particular the Private Finance Fund, went any way towards mitigating a clear concentration risk for an investor investing a substantial part of his available assets into the Funds. We accept in this respect the criticisms levelled by Mr Percival and Ms Clarke of SDAM's matrix and portfolio which, for example, would in principle result in a Low/Cautious investor being recommended to invest in Private Finance as to 50% and Absolute Return as to 40%.

112. Whilst we agree with Ms Clarke's submission that, on the evidence before us, there was a policy within SDAM to channel clients towards the Funds, by means of the matrix and the firm's buy list, we do not conclude that this was motivated by anything other than Mr Danner genuinely, if misguidedly, believing that the Funds were Low Risk and in the best interests of his clients. We do not consider that Mr Danner's investment recommendations were motivated by any financial advantage to himself. The FSA's case is not based on dishonesty. We should mention that Mr Evans made clear to us that, having known Mr Danner for a considerable time, he had always found him to be honest. As the issue of Mr Danner's honesty has not been pursued before us, we express no view on that matter. Our finding in respect of SDAM's matrix and portfolio is that it was a serious error of judgment on the part of Mr Danner not to have had sufficient (if any) regard to the concentration risk in constructing the matrix and portfolio. This was an error that would not, in our view, have been made by a competent and capable IFA.

113. Mr Danner's flawed approach to concentration risk is further evidenced by the case of Mr A. We have earlier concluded that Mr A was, for the purposes of his pension investment, a Low/Cautious investor. In those circumstances, Mr Danner recommended that more than 23% of Mr A's pension investment should be placed in the Investment Portfolio Fund, and 75% into the Private Finance Fund. In our view, even if those Funds could properly have been regarded as Low Risk, it would have been apparent to a competent and capable IFA that this level of concentration in funds in which substantial private investments were held, and particularly the Private Finance Fund, was wholly inappropriate for a pension investment. And if that would have been the case even if the Funds had been correctly classified as Low Risk, Mr Danner's failure to give proper consideration to the concentration risk is compounded by his failure also sufficiently to understand or question the risks attaching to the Funds and their underlying investments, which would, in our view, have caused a competent and capable IFA to adopt a very much more cautious approach to making recommendations to Mr A.

114. For these reasons we accept Ms Clarke's submission that Mr Danner was guilty of a serious failing of competence and capability. His conduct in espousing the CF Arch cru Funds in the way he did, in tailoring the matrix and portfolio towards such investments, and in recommending investments in the Funds to a Low/Cautious

pension investor in the case of Mr A, all fall short of what the investing public are entitled to expect from a competent and capable IFA.

115. The question remains whether the supervisory regime proposed by the Applicant is such as to eliminate future concerns as to the competence and capability of Mr Danner. We have referred earlier – in the context of our discussion of conflicts of interest – to the remote nature of that supervision model. We accept that the Applicant would not sanction Mr Danner recommending investments of the same nature as the CF Arch cru Funds. But that does not resolve the issue whether Mr Danner is a fit and proper person to perform the CF30 function.

116. In this regard we have the same reservations as we expressed in relation to conflicts of interest. Mr Danner has, in our judgment, failed to recognise or acknowledge the errors of judgement on his part that we have found were made in relation to the risks attaching to the Funds, the construction of the matrix and portfolio and the investment recommendations for Mr A. We do not consider that our concerns as to Mr Danner's competence and capability can be allayed by the supervisory approach proposed by the Applicant, or accordingly that our conclusions in these respects can be disturbed.

*Integrity*

117. Ms Clarke also submitted that the failings of Mr Danner were such as to go to the heart of the regulatory regime the purpose of which is to protect consumers such as Mr A, and are of such a serious nature as to demonstrate in Mr Danner a lack of integrity and reputation.

118. In her skeleton argument Ms Clarke referred us to *Hoodless and Blackwell v The Financial Services Authority* (3 October 2003) in the Financial Services and Markets Tribunal, in which the Tribunal described (at [19]) the expression "integrity" in the following terms:

> "In our view 'integrity' connotes moral soundness, rectitude and steady adherence to an ethical code. A person lacks integrity if unable to appreciate the distinction between what is honest and dishonest by ordinary standards."

119. This formulation was approved by this Tribunal in *Atlantic Law LLP and another v The Financial Services Authority* (Case no FIN/2009/0007), where it was pointed out that a person may lack integrity even though it is not established that he or she has been dishonest. It is, as was remarked in *Vukelic v The Financial Services Authority* (13 March 2009), unwise to attempt a comprehensive definition of integrity. But we agree with the guidance afforded by *Hoodless and Blackwell* and *Atlantic Law*. Even though a person might not have been dishonest, if they either lack an ethical compass, or their ethical compass to a material extent points them in the wrong direction, that person will lack integrity.

120. In our view, whilst we acknowledge that Mr Davies asked us to record that he himself had confidence in Mr Danner's integrity, we consider that the evidence points

to the opposite conclusion. Having regard to Mr Danner's position as a director and shareholder of CruIM, his continuing failure to appreciate or understand the conflict of interest between that and his responsibility in making investment recommendations to SDAM's clients, his lack of knowledge, understanding and competence in relation to the CF Arch cru Funds, his espousal of a matrix and portfolio heavily weighted in favour of those Funds, and his recommendation to Mr A to invest almost all his available funds for pension investment into the CF Arch cru Funds, demonstrates such a poorly-directed ethical compass in the case of Mr Danner as to amount to a lack of integrity on his part.

121. We do not consider that the proposed supervisory regime can eliminate the concerns as to Mr Danner's integrity.

*Financial soundness*

122. We can deal with the issue of financial soundness quite shortly. In our view, the existence of the disputed debt for which Mr Danner might become liable under a guarantee would not, of itself, be sufficient for us to conclude that we were not satisfied that he is a fit and proper person.

**Decision**

123. In the light of our conclusions on the issues of conflicts of interest and knowledge and understanding, and our overall conclusions as regards Mr Danner's competence and capability, and his integrity, we are not satisfied that Mr Danner is a fit and proper person to perform Controlled Function CF30.

124. This application is accordingly dismissed.

**ROGER BERNER**

**UPPER TRIBUNAL JUDGE**
**RELEASE DATE: 21 June 2012**